

INDEX

| | Page |
|--|------|
| Opinions below..... | 1 |
| Jurisdiction..... | 1 |
| Questions presented..... | 2 |
| Statutes and regulations involved..... | 2 |
| Statement..... | 2 |
| Specification of errors to be urged..... | 3 |
| Reasons for granting the writ..... | 4 |
| Conclusion..... | 7 |
| Appendix..... | 8 |

CITATIONS

Cases:

| | |
|---|------|
| <i>Bingham, Trust of v. Commissioner</i> , 325 U. S. 365..... | 6 |
| <i>Brewster v. Gage</i> , 280 U. S. 327..... | 5 |
| <i>Commissioner v. Estate of Bedford</i> , 325 U. S. 283..... | 6 |
| <i>Commissioner v. Levis' Estate</i> , 127 F. 2d 796, certiorari denied, 317 U. S. 645..... | 4, 6 |
| <i>Commissioner v. Wiesler</i> , 161 F. 2d 997..... | 4 |
| <i>Crane v. Commissioner</i> , 331 U. S. 1..... | 6 |
| <i>Dart v. Commissioner</i> , 74 F. 2d 845..... | 4 |
| <i>Dobson v. Commissioner</i> , 320 U. S. 489..... | 6, 7 |
| <i>Fawcus Machine Co. v. United States</i> , 282 U. S. 375..... | 5 |
| <i>Helvering v. Wilmington Trust Co.</i> , 124 F. 2d 156, reversed, 316 U. S. 164..... | 4 |
| <i>Helvering v. Winmill</i> , 305 U. S. 79..... | 4 |
| <i>Kelley, John Co. v. Commissioner</i> , 326 U. S. 521..... | 6 |
| <i>McWilliams v. Commissioner</i> , 331 U. S. 694..... | 6 |
| <i>Spreckels v. Commissioner</i> , 119 F. 2d 667, affirmed, 315 U. S. 626..... | 5 |

Statutes:

Internal Revenue Code:

| | |
|--|----------|
| Sec. 23 (26 U. S. C. 1940 ed., Sec. 23)..... | 4, 8, 10 |
| Sec. 113 (26 U. S. C. 1940 ed., Sec. 113)..... | 5, 9 |
| Sec. 117 (26 U. S. C. 1940 ed., Sec. 117)..... | 10 |
| Revenue Act of 1938, c. 289, 52 Stat. 447: | |
| Sec. 23..... | 10 |
| Sec. 113..... | 10 |
| Sec. 117..... | 10 |

The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Whether amounts paid in lieu of dividends on borrowed stock used to cover short sales are deductible as business expenses under Section 23 (a) of the Revenue Act of 1938 and the Internal Revenue Code, or are, in accordance with Treasury practice of long standing, capital items constituting part of the cost basis of the shares purchased to reimburse the lender.

2. Whether review of the Tax Court's decision by the court below is restricted by *Dobson v. Commissioner*.

STATUTES AND REGULATIONS INVOLVED

The pertinent statutes and regulations are printed in the Appendix, *infra*, pp. 8-12.

STATEMENT

The facts, presented to the Tax Court by stipulation (R. 57-62), were adopted by it as the findings of fact (R. 48) as follows:

The taxpayer filed his individual income tax returns for the calendar years 1938 to 1940, inclusive, on the cash basis. During the taxable years 1938, 1939, and 1940, he was married and had no dependents. (R. 58.)

Throughout the taxable years 1938, 1939, and 1940, the taxpayer was engaged in the business of trading in securities on his own account, includ-

ing an extensive volume of short sales of securities, and continuously had a short position. (R. 58.) During the taxable years, the taxpayer paid dividends on stock on which he had a short position as follows (R. 59):

| | |
|-----------|-------------|
| 1938..... | \$19,242.62 |
| 1939..... | 23,557.34 |
| 1940..... | 28,044.69 |

The Tax Court held that the taxpayer was entitled to deduct the payments of \$19,242.62, \$23,557.34 and \$28,044.69 as business expenses in the years paid. (R. 48-49.) The Circuit Court of Appeals for the Ninth Circuit affirmed on the merits and also held that its review was limited by *Dobson v. Commissioner*, 320 U. S. 489.

SPECIFICATION OF ERRORS TO BE URGED

The court below erred:

1. In holding that amounts paid in lieu of dividends on stock borrowed to cover short sales are deductible as ordinary and necessary expenses under Section 23 (a) of the Internal Revenue Code.

2. In failing to hold that amounts paid in lieu of dividends on stock borrowed to cover short sales constitute a part of the cost basis of the shares subsequently purchased to reimburse the lender.

3. In holding that the rule of *Dobson v. Commissioner* restricts the review of the Tax Court's decision in this case.

4. In affirming the decision of the Tax Court.

REASONS FOR GRANTING THE WRIT

1. The decision of the court below is in direct conflict with the decisions of the Circuit Court of Appeals for the Second Circuit in *Commissioner v. Levis' Estate*, 127 F. 2d 796, certiorari denied, 317 U. S. 645, and the Circuit Court of Appeals for the Third Circuit in *Helvering v. Wilmington Trust Co.*, 124 F. 2d 156, reversed on other grounds, 316 U. S. 164. The decision accords with *Dart v. Commissioner*, 74 F. 2d 845 (C. C. A. 4), and *Commissioner v. Wiesler*, 161 F. 2d 997 (C. C. A. 6), in which latter case a petition for certiorari is now being filed, No. 421.

The decisions all present the same factual situation of a trader in securities who borrows shares of stock to cover short sales and is required to reimburse the lender for dividends declared on such shares during the loan period and prior to the time when other shares are purchased to repay the lender in kind. In every case the question arises whether the payments in lieu of dividends are capital items (comparable, for example, to purchase commissions which must be added to the cost basis in computing gain or loss on the sale, *Helvering v. Winmill*, 305 U. S. 79) or are "ordinary and necessary expenses" within the meaning of Section 23 (a) of the Internal Revenue Code, and deductible as such.

The direct conflict among circuits and the recurring nature of the problem clearly provide an

appropriate occasion for this Court to review the decision below.

2. The decision below reverses a long established administrative practice which has consistently required that these substituted dividend payments be added to the cost basis of the covering securities. I. T. 1764, II-2 Cum. Bull. 22, 23 (1923); S. M. 4281, IV-2 Cum. Bull. 187, 189 (1925). This administrative practice is entitled to great weight. *Brewster v. Gage*, 280 U. S. 327; *Fawcus Machine Co. v. United States*, 282 U. S. 375. Cf. *Spreckels v. Commissioner*, 119 F. 2d 667, 670-671 (C. C. A. 9), affirmed, 315 U. S. 626. The practice is a reasonable one, consistent with accounting principles, and imposes no hardship. The taxpayer is entitled to full credit for the charges in computing his capital gain or loss since they are included in the adjusted cost basis under Section 113 (b) (1) (A) of the Internal Revenue Code, Appendix, *infra*. In view of a consistent practice of some twenty-five years, it is a matter of considerable importance to the administration of the tax law that this decision be reviewed; for, the Treasury should not be required to abandon that practice in the absence of an authoritative decision by this Court, particularly since there is a conflict of views among the circuits.

3. The court below not only decided the merits of the question but also determined that the Tax

Court's decision could not be reversed in view of *Dobson v. Commissioner*, 320 U. S. 489. (R. 74.) This view conflicts with the rationale of this Court's decisions in *Trust of Bingham v. Commissioner*, 325 U. S. 365, 370-371; *John Kelley Co. v. Commissioner*, 326 U. S. 521, 529-530; *Crane v. Commissioner*, 331 U. S. 1, 15; *McWilliams v. Commissioner*, 331 U. S. 694.

The Tax Court's decision turns "on a generalizing principle" (*Commissioner v. Estate of Bedford*, 325 U. S. 283, 292) and provides "a rule of general applicability" which affords "concrete guidance for future cases" (*Trust of Bingham v. Commissioner, supra*, p. 370). The determination in each case of whether the payments on borrowed stock are capital items will not depend on factual differences or inferences to be drawn therefrom but rather on a general principle of interpretation controlling in all short sale transactions.

This is evident from the recognition by the Tax Court that it was choosing the rule of *Dart v. Commissioner, supra*, in preference to the contrary rule of *Commissioner v. Levis' Estate, supra*. Similarly the court below explicitly recognized the conflict among the decisions and chose the *Dart* rule. (R. 74.) (In so doing it also apparently rejected the administrative rulings to which we have referred. Cf. *Dobson v. Commis-*

sioner, *supra*, p. 503.) Such a conflict could scarcely exist in the absence of a difference of opinion as to the applicable rule of law.

Accordingly, we submit that the decision in this case states a rule of general applicability, the review of which is not limited by *Dobson v. Commissioner*.

CONCLUSION

It is respectfully submitted that this petition for a writ of certiorari should be granted.

PHILIP B. PERLMAN,
Solicitor General.

OCTOBER 1947.

APPENDIX

Internal Revenue Code:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) [as amended by Sec. 121 (a) and (d), of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Expenses.*—

(1) *Trade or business expenses.*—

(A) *In general.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

* * * * *

(2) *Non-trade or non-business expenses.*—In the case of an individual all the ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income.

* * * * *

(g) *Capital losses.*—

(1) *Limitation.*—Losses from sales or exchanges of capital assets shall be allowed only to the extent provided in section 117. (26 U. S. C. 1940 ed., Sec. 23.)

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (unadjusted) of property.*—The basis of property shall be the cost of such property; * * *

(b) *Adjusted basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as herein-after provided.

(1) *General rule.*—Proper adjustment in respect of the property shall in all cases be made—

(A) For expenditures, receipts, losses, or other items, properly chargeable to capital account, including taxes and other carrying charges on unimproved and unproductive real property, but no such adjustment shall be made for taxes or other carrying charges for which deductions have been taken by the taxpayer in determining net income for the taxable year or prior taxable years; * * *

(26 U. S. C. 1940 ed., Sec. 113.)

SEC. 117. CAPITAL GAINS AND LOSSES.

(g) *Gains and Losses From Short Sales, Etc.*—For the purpose of this chapter—

(1) gains or losses from short sales of property shall be considered as gains or

losses from sales or exchanges of capital assets;

* * * * *

(26 U. S. C. 1940 ed., Sec. 117.)

The Code provisions set forth above are applicable to tax years 1939 and 1940. Sections 23 (a) (1) and (g) (1), 113 (a) and (b) (1) (A) and 117 (g) (1) of the Revenue Act of 1938, c. 289, 52 Stat. 447, are similar and are not repeated. Section 23 (a) (2), Internal Revenue Code, was added to the Code by Section 121 of the Revenue Act of 1942 and was made retroactive to tax years beginning after December 31, 1938.

Treasury Regulations 103, promulgated under the Internal Revenue Code:

SEC. 19.23 (a)-1 [as amended by T. D. 5166, 1942-2 Cum. Bull. 87]. *Business expenses*.—Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, except the classes of items which are deductible under sections 23 (b) to 23 (s), inclusive, and the regulations thereunder. Double deductions are not permitted. Amounts deducted under one provision of the Internal Revenue Code cannot again be deducted under any other provision thereof. As to charitable contributions by corporations not deductible under section 23 (a), see section 19.23 (a)-13. The cost of goods purchased for resale, with proper adjustment for opening and closing inventories, is deducted from gross sales in computing gross income. (See section 19.22 (a)-5.) Among the items included in business expenses are manage-

ment expenses, commissions (but see section 19.24-2), labor, supplies, incidental repairs, operating expenses of automobiles used in the trade or business, traveling expenses while away from home solely in the pursuit of a trade or business (see section 19.23 (a)-2), advertising and other selling expenses, together with insurance premiums against fire, storm, theft, accident, or other similar losses in the case of a business, and rental for the use of business property. Penalty payments with respect to Federal taxes, whether on account of negligence, delinquency, or fraud, are not deductible from gross income. The full amount of the allowable deduction for ordinary and necessary expenses in carrying on a business is nevertheless deductible, even though such expenses exceed the gross income derived during the taxable year from such business. As to items not deductible under any provision of section 23, see section 24.

SEC. 19.23 (a)-15 [as added by T. D. 5196, 1942-2 Cum. Bull. 96]. *Nontrade or nonbusiness expenses*.—(a) *In general*.—Subject to the qualifications and limitations in chapter 1 and particularly in section 24, as amended, an expense may be deducted under section 23 (a) (2) only upon the condition that:

(1) it has been paid or incurred by the taxpayer during the taxable year (i) for the production or collection of income which, if and when realized, will be required to be included in income for Federal income tax purposes, or (ii) for the management, conservation, or maintenance of property held for the production of such income; and

(2) it is an ordinary and necessary expense for either or both of the purposes stated in (1) above.

* * * * *

SEC. 19.117-6. *Gains and losses from short sales.*—For income tax purposes, a short sale is not deemed to be consummated until delivery of property to cover the short sale, and the percentage of the recognized gain or loss to be taken into account under section 117 (b) from a short sale shall be computed according to the period for which the property so delivered was held. Thus, if a taxpayer made a short sale of shares of stock and covered the short sale by purchasing and delivering shares which he held for not more than six months, 100 percent of the recognized gain or loss would be taken into account under section 117 (b), even though he had on hand other shares of the same stock which he held for more than six months. If the short sale is made through a broker and the broker borrows property to make delivery, the short sale is not deemed to be consummated until the obligation of the seller created by the short sale is finally discharged by delivery of property to the broker to replace the property borrowed by the broker.

Insofar as pertinent to the instant case, Articles 23 (a)-1 and 117-6, Treasury Regulations 101, applicable under the Revenue Act of 1938, are similar to the foregoing provisions and are not repeated.